HELP ?

Russia's collapse

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Abstract:
Most people think that Russia's economic problems are due to the shock of fast and radical reforms. Actually, the Russian economy is not very liberalized at all, and its problems have been caused by reforms that were too slow and partial, not too sweeping. Russia suffers not from too free a market but from corruption, which thrives by preying on an unwieldy bureaucracy. Still, the outlook for the months ahead is promising. The private sector got a salutary wake-up call from the 1998 collapse of the ruble, and the strength of the political center bodes well for economic recovery and social change.

Full Text:

WINNER TAKES ALL

RUSSIA's ECONOMY remains precarious after the August 1998 financial collapse. Gross domestic product fell by 4.6 percent last year and may fall by another percentage point in 1999. Except for 1997, GDP has decreased every year for the past decade, with an accumulated decline since 1991 of 40 percent. Inflation rose to 84 percent in 1998 and remains high. Yet Russia may have finally passed its nadir. Industrial production will likely increase significantly this year, and the fastest-- growing industries are not raw materials but machinery, forestry, textiles, food, and construction materials, suggesting a qualitative change. Western policymakers should resist the urge to just throw more money at Russia and instead rethink what the West can and should do to help.

Many argue that Russia fared badly because its "shock therapy" reforms were too fast and radical. But all measures show that Russia's economy is not very liberalized, and the financial collapse made it obvious that Russia's problems were actually caused by reforms that were too slow and partial. A small group of businessmen enriched themselves and then corrupted many of Russia's politicians and officials. They have all conspired to stymie liberal economic reforms, which would stimulate growth and help the overall population, because reform threatens their domination. Russia suffers not from too free a market but from corruption thriving on the excessive regulations erected by a large and pervasive state. Russia's tragedy is that reformers never had enough power to overrule these avaricious interests. Joel Hellman of the European Bank for Reconstruction and Development characterizes the problem of partial reform as "winners take all."

Russia is no longer a mystery; it is more open than ever. Anyone who has visited a Russian enterprise recently understands why the economy is shrinking. Tax legislation is contradictory and full of loopholes, and many collectors work beyond the law. Russia has about 200 different levies, most of which hardly reap any revenue but create red tape for businesses. The taxman collects as much as he dares, taking a lot from small enterprises without political connections and little from big, powerful companies. Although fundamental tax reform has been urgently needed for years, it has been blocked by influential businessmen who now pay little or no taxes.

These big businessmen also benefit from Russia's arduous regulations and pitiless inspectors, which limit competition but do not impede the powerful. An ordinary Russian firm is inspected almost daily by one of the 67 different government agencies engaged in business supervision. These agencies' real interest is in extorting bribes. Between 1992 and 1998, when Viktor S. Chernomyrdin was prime minister, the Russian state expanded by 1.2 million bureaucrats-almost two percent of the total labor force. Their ubiquitous interference has limited legally registered enterprises to just 1 per 55 people, whereas Poland, Hungary, and Western countries have about 1 per 10 people. This lack of competition brings high prices and poor supply.

THE RICH GET RICHER

RUSSIA'S ELITES started making their fortunes in the Soviet Union's last years, mostly from three sources: commodity exports, subsidized credits, and food imports.

The best way to make a killing between the late 198os and 1993 was to buy commodities such as metals or oil at low, state-controlled prices in Russia and then sell them abroad at world prices. In early 199o, for example, the Moscow free-market price of a package of Marlboro cigarettes was 30 rubles-exactly the same price as a ton of crude oil. This lucrative opportunity was the result of Mikhail S. Gorbachev's partial liberalization, which let thousands of enterprises pursue foreign trade. In 1988, state enterprise managers were allowed to set up private cooperatives for arbitrage with "their" government-- owned businesses. Managers of state oil companies bought oil from their enterprises privately, extracted export licenses and quotas from corrupt officials, and sold the oil abroad at the market price.

In the first months of 1992, under the leadership of Deputy Prime Minister Yegor Gaidar, the reformers tried to end this rampant embezzlement by freeing Russia's commodity prices and exports. The state energy lobby, led by Chernomyrdin and supported by the Communists, resisted ferociously. Hypocritically, they argued that Russia's industry would collapse if it faced world market prices. The business elites and their political allies won. Chernomyrdin succeeded Gaidar's liberal minister of energy in May 1992 and soon supplanted Gaidar himself. In 1992, the Russian price of oil was still one percent of the world market price. A few state enterprise managers, government officials, politicians, and commodity traders amassed no less than $24 billion, or 30 percent of Russia's GDP, in this peak year of gains from commodity trading. These profits gradually dwindled. Eventually, the reformers succeeded in deregulating commodity prices, but only after managers had extracted billions of dollars from their state enterprises.

Business elites had an alternative way of making money in the early 1990s: cheap credits from the Russian Central Bank. Under the Soviet system, interest rates had no economic function and were fixed at three percent a year. Reformers failed to gain control of the Central Bank, which was supervised by the old semidemocratic Supreme Soviet, after communism's fall. The Supreme Soviet's chair, Ruslan

Khasbulatov, pressed hard for cheap credits and triumphed. In 1992, while inflation was 2,500 percent, the bank issued credits at 10 or 25 percent a year. A credit from the Central Bank was simply a gift. The man who distributed the most gifts was Viktor Gerashchenko, the chair of the bank. He made himself so popular with his generous presents at the Russian public's expense that his friends made him chair for the third time in September 1998.

In 1992 alone, the net credit issue of the Central Bank of Russia was 32 percent of GDP. Although the fortunes thus gained were more dispersed than those from commodity exports, many Russian bankers became rich. The bankers argued that the credit was a "Keynesian" boost for industrial production, but Russia's production actually plummeted in the wake of the hyperinflation caused by the easy credit. Only in late 1993 did the reformers manage to end this pilfering.

A third way of making big money in the transition period was through food-import subsidies. In the winter of 1991-92, the fear of famine was very real. The reformers thus had no chance to abolish the existing subsidies for food. A food importer paid only one percent of the going exchange rate when purchasing essential foods from abroad, but could resell them relatively freely on the domestic market and pocket the subsidy. These imports were paid for with Western "humanitarian" export credits that were added to Russia's state debt. Total import subsidies were 17.5 percent of Russia's GDP in 1992. These profits were highly concentrated, benefiting a limited number of traders in Moscow who operated through the old state agricultural monopolies. The main actor was Roskhleboprodukt, a company that arose from Stalin's old Ministry of Grain Procurement, and one of the instigators was the prereform deputy prime minister for agriculture, Gennady Kulik. He returned to that post in September 1998 to take care of renewed Western food aid, also to be channeled through Roskhleboprodukt.

Enlarge 200%
Enlarge 400%

Wild and crazy guys: "New Russians"at play, Moscow, 199o

Altogether, the gains from these three parasitic business activities amounted to no less than 79 percent of GDP in 1992. Most of the profits were highly concentrated among a small elite. And all these massive private incomes were derived from the government, either directly from subsidies or indirectly through regulations. The rise of the oligarchs was a direct result of slow and partial reforms. If commodity prices, exports, and imports had been deregulated in 1992 and if market interest rates had been allowed to prevail, these fortunes would never have been made. Russian enterprises would have been forced to restructure to survive, as happened in Poland and Estonia. Instead, Russia moved swiftly from an income differentiation similar to Europe's to one reminiscent of Latin America's.

DID REFORM FAIL?

ONE OF the few important steps that reformers actually managed to take was privatization. Strangely, this single reform is often blamed for all of Russia's misfortunes. Shares of nearly all big enterprises are traded on Russia's stock market, making it a good indicator of the market value of public companies. At the market's peak in 1997, all of Russia's enterprises together had a market value of only twenty percent of GDP; today they are worth five percent of GDP, and the GDP is half as large in dollar terms. The managers of the companies then owned about one-fifth of their stocks. Thus in total they obtained at most four percent of GDP from privatization, a trifle compared to the profits made through regulated exports, subsidized credits, and import subsidies.

Privatization was blamed for several reasons. First, since it was the only open and transparent transfer of wealth, everyone saw it, whereas they could not see the far larger financial flows. Second, few noticed that the oil managers had become tremendously wealthy before privatization and had actually resisted it, or knew that bankers used wealth gained from subsidized credits and commodity trade to buy enterprises. Finally, the reformers had unwisely boosted popular expectations of gains to facilitate privatization politically, which ultimately aroused disappointment. People tend to overestimate the value of huge smokestacks-who can really fathom that Microsoft is worth more than General Motors? Few realized that old Soviet enterprises were of little or no value, so people suspected that somebody else had stolen their share.

The loans-for-shares deals at the end of 1995 were a scandal that blemished First Deputy Prime Minister Anatoli Chubais and damaged the reputation of large-scale privatization. A few large banks were allowed to privatize some large enterprises in auctions they themselves controlled. In fact, only 15 large enterprises were involved and in some cases sold only a small share of their stock. But a few huge cash cows did change hands, most notably three big oil companies: Yukos, Sibneft, and Sidanko. No qualitative change accompanied these takeovers. The new majority owners did not behave like self--interested proprietors but just continued the management theft, primarily by selling the products below market prices to their own trading companies, letting the old state companies deteriorate. After a short-lived boom, these companies' values fell below their low purchase prices. For instance, Norilsk Nickel, the large metal company, was long worth less than what Oneximbank paid for it in a 1995 noncompetitive deal. In 1998, the big new "capitalists" showed yet again that they could not care less for the market value of their enterprises. Many minority shareholders responded by selling off their holdings. The Russian stock index consequently dove 94 percent from its peak in 1997. After the financial crash, these businessmen attempted to extract more money from the state-fortunately, there was little left to take.

Clearly, privatization has not caused Russia's economic problems. Privatization's severest critics have always been those very elites who seemed to profit from it, since the emergence of real private property rights threatens their state-oriented way of making money. The problem is not that businesses are formally private but that state officials' extensive and arbitrary interventions severely limit private property rights. It is difficult to talk about truly private ownership when the Communist opposition keeps most land state-owned. Russia's greatest problem is that a few operators have made fortunes on inconsistent government regulations and subsidies. True, widespread corruption in the late 198os sealed the fate of the Communist dictatorship and facilitated its peaceful end, as many members of the elite became more concerned with creating their own wealth than with promoting socialism. But the Soviet directors made so much money that they soon bought the state. Today, the Russian bureaucracy, government, parliament, and regional governments are deeply corrupt.

But though privatization has not been as successful as the reformers hoped, some positive changes have been implemented. Many Soviet-era managers have been replaced, which is often a precondition for restructuring. (This failed to happen in post-Soviet countries with little privatization, such as Belarus and Ukraine.) Thirty-three percent of the managers at privatized Russian enterprises were replaced between 1992 and 1996. A recent broad survey shows substantial market-directed restructuring, although this process has been much faster in countries with more radical reforms. And the privatization might eventually generate more important and widespread positive results. After all, Russia now sports 2.7 million legally registered private enterprises. After the first crop of corrupt big businessmen has lost most of its money, a second echelon of businessmen that have actually made money on entrepreneurship may arise.

TOO BIG AND TOO NUCLEAR?

RUSSIA'S CURRENT tragic situation-corrupt politics, bankrupted economy, enormous debts-was not inevitable, but its probability was always great. A 1997 World Bank paper shows that the worse the initial conditions are for reform in a postcommunist country, the more likely reform will fail. Good policies, however, can overcome adverse preconditions. Countries that undertook massive reforms in spite of all difficulties, such as the Baltic states, Georgia, and Kyrgyzstan, have reaped the greatest rewards. Therefore, Prime Minister Gaidar and his reform government were anxious to reform Russia's economy radically before the resistance got organized.

Western countries had one big chance to make a difference, at the beginning of 1992. The West, especially the United States, enjoyed enormous goodwill and influence in Russia. It should have used this power to push for all the measures necessary for Russia's complete economic reform-liberalization of commodity prices, deregulation of exports, unification of the exchange rate, and establishment of market interest rates-which are standard elements of any International Monetary Fund (IMF) program. President Boris Yeltsin appealed to the West for help, but in vain. The IMF concluded a minor agreement in July 1992, but by then Russia's reformers had already been defeated, in part because they had counted on the West's help. Instead, Western countries were preoccupied with securing repayment of the Soviet debt. Rather than providing money for reforms, they gave credits to dubious commodity traders.

A remorseful West has repeatedly tried to make amends for its initial lack of action. But its support, primarily through the IMF, has gone to far less reformist governments, and the results have been mixed. The high point of the IMF'S engagement in Russia was in the spring of 1995, with an agreement that halved the budget deficit to five percent of GDP and augured low inflation. Chubais ran economic policy so skillfully in 1995 that he cut budget subsidies by seven percent of GDP. In January 1996, however, he was ousted and no senior reformers remained in the government. Even so, in the spring of i996 the IMF provided a $io billion loan program over 3 years, although the government was not committed to any reform. The political purpose of this IMF credit was obvious to everybody: helping reelect President Yeltsin in the face of a potent Communist threat. The IMF lost its economic credibility.

To Russians and foreign investors alike, the signal was clear: Russia was too big and too nuclear to fail. This encouraged an excessive inflow of foreign portfolio investments. In 1997, they amounted to $46 billion, or over ten percent of GDP-far more than Russia could absorb. The consequences became evident on August 17,1998, when Russia suffered a cataclysmic crash. The government defaulted on its treasury bills and declared a go-day moratorium on foreign debt payments. The ruble has since been devalued to one-fourth its original value.

SLOW-MOTION COLLAPSE

THE STRANGE thing about the Russian financial collapse is that it was clearly underway from October 1997, when the stock market fell 20 percent in a day, and yet did not provoke sufficient policy changes. Interest rates repeatedly exceeded 100 percent annually, although inflation only ran around 10 percent a year. The crisis was discussed for months, and the crucial statistics were widely available. The Russian administration, the IMF, and the West all pushed for the same package of sensible policies, which was presented to the Duma in July 1998. The Duma, with the support of most of the business elite, coldly rejected it, pushing their country over the brink into a financial abyss.

Why did the business elite want to kill the crisis-relief package? They were hardly ignorant of the consequences. Partly, the answer is that their whole business experience had encouraged and rewarded them for gambling on the margin; they had learned to call bluffs. Since they had made most of their money by cheating the state, Russian national interests were not a compelling argument. Another explanation is that the top Russian businessmen were used to switching sources of revenues swiftly. To them, each game was played only once. If they deterred some Western investors, they presumed new ones would appear. The majority owners of the oil companies Sidanko and Sibneft, for example, had made much of their money by diluting minority ownership in 1997 and 1998. Yet British Petroleum and Elf Aquitaine still attempted to buy ten percent of their shares. Within these Moscow business circles, a good reputation meant not honesty but crookedness. Finally, many Russian businessmen had learned that foreign investors were people just asking to be robbed. The 1997 foreign investment inflow was so huge that some tycoons concluded they had better take the money while they could. No law could have secured these massive inflows. Total foreign stock ownership in Russia peaked in late 1997 at about 30 percent of market capitalization-about $3 billion, or 7 percent of GDP. These poorly defended assets were too tempting for many Russian businessmen.

Government bonds were hardly better. In July igg8, at least $25 billion of the $70 billion of outstanding Russian treasury bills-some six percent of GDP-was held by foreigners. They provided revolving credit to the Russian government, easing Russian enterprises' need to pay taxes but still permitting them the cake of government subsidies. Private and regional bond issues were even worse, with poor guarantees of repayment. In addition, influential businessmen boosted interest rates by inciting the ruble's destabilization. As long as the ruble did not actually collapse, this was a profitable gamble, with real returns reaching loo percent a year. Although IMF and World Bank funding was supposedly conditioned on economic reform, those who benefited from state intervention often managed to block liberalization, sometimes after the international loans had arrived. The IMF seemed to be there to be cheated.

The financial crash, however, brought huge losses to almost all the big Russian businessmen. They had been amazingly successful in finding new ways of living off the state, but their annual revenues had declined since 1992. The tycoons looked increasingly reckless, desperate, and acrimonious. In July 1997, open privatization bidding for the telecommunications company Svyazinvest triggered a particularly fierce struggle between some of the biggest businessmen. As Andrei Shleifer of Harvard and Robert W. Vishny of the University of Chicago have observed, the best way of fighting corruption is encouraging competition in bribery. August's financial crisis was a logical outcome of the oligarchs' war, as they tried to maintain their high and dubious incomes by any means. In the end, the Russian state could no longer deliver enough cash to satisfy their ravenous appetites. The crash radically reduced the amount of money that could be made on the state-and thus the power of the corrupt businessmen.

SAVING PRIVATIZED RUSSIA

A TELLING JOKE is making the rounds in Moscow: There are two ways out of the Russian economic crisis: the natural and the miraculous. The natural way is that the archangel Michael and all the angels come down to earth and work 12 hours a day to save the Russian economy. The miraculous way is that the Russians do it themselves. In the same spirit, big billboards announce, "Nobody will help Russia apart from ourselves."

Russians largely realize that the days of easy money are over, that the outside world will not help them out, and that the only solution to economic hardship is hard work. Previously, few discussed the future, but now the time horizon has suddenly been extended. Another joke has the Russian power utility announce that the light at the end of the tunnel has been turned off temporarily for lack of fuel. Whereas Russian wisecracks during the early 199os concerned the newly rich, they now feature newly poor bankers. Russia has grown more serious.

I had heard the anecdote about the archangel Michael before-in Poland, after martial law was introduced in December 1981. The grim atmospheres in Poland then and Russia now are strikingly similar. Whatever people say about the failure of economic liberalism in Russia, most Russians know that the only viable option remains a reasonably normal market economy. Even the Communist politicians accept it. As in Poland in 1981, however, that outcome seems politically impossible in today's Russia.

Still, Poland could be an illuminating example. It is now a stunning economic success, with a steady growth rate of five to six percent a year. Transparency International shows that it is one of the most honest countries in central Europe, after Estonia. Few remember Poland's reputation for being the most corrupt country in the region in the late 1970s. Members of the elite enriched themselves at state expense with few inhibitions. Poland abounded with explanations for why Poles were so dishonest, ranging from pervasive Catholicism to the state's lack of legitimacy because of persistent foreign occupation. It is amazing how fast historical legacies can change, but Poland suffered two severe financial crashes on the way.

In a decade, the West might realize that Russia is one of the oldest nations with one of the strongest cultures in Europe. It has heretofore suffered from one serious anomaly: the extreme dominance of the state. Future analysts might consider it self-evident that once that domination disappeared, as it now has, a newly dynamic Russia would flourish. And Russians continue to enjoy high levels of math and engineering education-the backbone of the Internet world.

An important part of the explanation for Poland's turnaround is that Poland then-like Russia now-had such ferocious competition in bribes that they began to decline. Rational people who wanted to make money turned to the market instead. Over the course of the 198os, ordinary Poles learned how their society actually functioned and a majority opted for change. With a reformist majority elected to parliament in 1989, radical reform became possible in Poland. One can only hope that the Russian electorate comes to similar conclusions.

TRADE, NOT AID

THE RUSSIAN experience shows that it is not enough to have a brief reformist government and an intermittently proreform president. Consecutive Russian parliaments have continuously voted against serious market liberalization; real reformers were in power only from November 1991 to June 1992. The barrier to reform has never been the people or the workers, who have been exceedingly complacent. The threat has always come from elites who want to live on corruption-and the best way of controlling them is through effective democracy. President Yeltsin missed the opportunity to call early parliamentary elections in 1991-92 and transform the Democratic Russia movement into a real political party.

The financial breakdown caused tremendous suffering in Russia, but such a shock can mark a turning point. One instant change was a sharp reduction in income differentials, since the prime victim of the crash was the new financial sector. The most apparent effect was a backlash against the market liberals in the government, who should have resigned in July after the Duma rejected their tax and reform legislation. The best they can do is organize a broad political party for the distant future, as they are now doing.

The much-feared political backlash, however, now appears surprisingly insignificant. On May 12, in full constitutional order, President Yeltsin dismissed Prime Minister Primakov and replaced him with Sergei Stepashin. Yeltsin's boldness forced the Communists to unleash the long-held threat of impeachment, which failed to carry the Duma. Yeltsin and Russia's centrist forces thus won three victories for political stability and democracy in one week. Similarly, the expected retreat in economic policy never occurred. The Communist ministers under Primakov had big ideas about massive regulations and new credit but they accomplished little. Their plans were leaked to the press and ridiculed. In the end, Primakov's economic program was remarkably similar to those of previous governments. Stepashin looks set to differ even less from his predecessors, as he has yet to formulate independent economic policy. Russia thus appears to have reached a stable political consensus around moderate market reforms.

The financial meltdown had important effects on the real economy. Total state revenues have fallen from a steady 32 percent of GDP to about 28 percent. Rather than being concerned, the West should welcome the inevitable reduction in public expenditures. After all, as a share of GDP, Russian state revenues were as large as those of the United States even last year. Lower real taxes will diminish the value of the privileged's tax exemption and make it easier to cut the overall tax rate. Unwarranted public expenditures will have to be cut by about 5 percent of GDP. This should not hurt the poor. A study by the Russian Ministry of Labor and Social Affairs last year showed that 70 percent of social transfers go to the wealthiest 30 percent of households. Smaller and correspondingly more transparent public expenditures could be more easily targeted to the most needy. Lower state revenues have already forced cuts in the bureaucracy and will facilitate deregulation, letting businesses function better. Radical tax reforms elsewhere in the region occurred in countries such as Georgia, Kyrgyzstan, and Kazakhstan only after tax revenues had collapsed. Most important, there would be little money to be made on state interventions. Smart businessmen will turn to the market, as their Polish colleagues did in the 1980s.

At long last, business restructuring and new product development appear to have caught on. Moscow shops have been suddenly flooded with good Russian produce, in many cases last seen in the 196os. Barter is abating, from 54 percent of industrial firms' sales in August 1998 to 46 percent in January 1999. Major companies paid 49 percent of their February 1999 taxes in real money, compared with only 35 percent last August. Bankruptcies have multiplied, forcing malfunctioning companies out and allowing good companies to thrive. Profitability is improving. The financial crisis imposed hard budget constraints on both businesses and governments, which pushed them to achieve real economic growth.

If Russia is to be cured, the elite must be forced to continue facing strict budget constraints. Russia must not be tempted again with easy money. As foreign capital constituted the last big wave of financing, the West, including the IMF and the World Bank, should be careful not to ease the external financial constraints too quickly. But the ruble's devaluation has sharply cut imports and turned around Russia's external finances. The country is likely to enjoy a $25 billion trade surplus and a $15 billion current account surplus in 1999. Russia is therefore unlikely to default on its external debt, even if it receives no IMF or World Bank funding this year. Poland's experience in the 1980s is instructive. It received no new Western funding but was not cut off from ordinary business. The country also benefited from millions of Poles traveling, studying, and working in the West-opportunities that Russians should have. Western policy today must maintain the maximum possible openness for trade and all kinds of exchanges but disperse a minimum of financing as long as serious reforms are not in evidence. Debt relief should be concluded only after fundamental economic reforms. The Russian stock index has tripled since October 1998, indicating that there is renewed reason to worry about too much foreign portfolio investment too quickly.

Russian politics remain in flux, but the recent government crisis demonstrates that a large center now dominates. The next parliamentary and presidential elections will likely produce a more centrist parliament, with strong regional representation. A centrist will likely be the next president, who will be weaker than Yeltsin and cede more power to the parliament and the regions. This will promote greater democracy. Although the serious problem of rampant corruption remains, Russian media do a fine job of exposing it, and dwindling state resources leave less to be stolen.

Russia is slowly waking up after a tremendous trauma. With any luck, this economic shock has triggered a fundamental change in social values, but any such change will take years to complete.

[Author note]

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